

Australia: The Land of Opportunity?

During March members of the Devon investment team travelled to Australia for an extensive research trip. We visited Brisbane, Sydney and Melbourne and met with around 30 companies, spanning across the financials, resources, legal services, retail, media, agriculture, gaming, aged care and property sectors. Following our visit we increased positions in Slater and Gordon and Scentre (the owner of the Australasian Westfield malls) and are also reviewing a number of potentially interesting new investments for inclusion in Portfolios.

Although the Australian equity market has performed very strongly over the year to date and has seen average valuation multiples increase to around 16x earnings (12 months forward), we still believe there are better investment opportunities within that market than New Zealand. The main Australian equity market index, the ASX200, contains stocks valued at close to A\$1.6 trillion – by comparison the NZX50 has a market capitalisation of just NZ\$65bn. A key attraction of the ASX for investors is the breadth of sectors and individual stocks. There is also an interesting small company sector where we believe there are still significant opportunities to make money. We met approximately 10 companies in this category during our visit to Australia, a number of which appear undervalued by the market.

Many of the Australian economic headlines are negative at the moment but this actually creates opportunities for bottom-up stock pickers and after our trip we see a number of positives emerging. Interest rates remain low (the cash rate is 2.25% which is 1.25% below NZ) and consensus forecasts expect further cuts by the RBA of up to 0.5%. The housing market continues to respond positively to the interest rate environment and while consumer confidence is subdued, retail sales still rose 4.5% year-on-year in January (ex-food) highlighting the wealth effect of positive house price inflation. In addition, around 25% of the ASX 200 revenue (excluding resources) is generated off-shore where volume growth has typically been stronger and the weaker AUD (against the USD) has been a material positive.

The AUD has fallen by 27% against the USD over the past year. This reflects the divergent interest rate expectancy and the impact of a weaker Chinese economy on commodity prices, in particular iron ore, coal and oil. China data has remained weak in recent months resulting in the introduction of stimulus to support the deepening property downturn, although further easing may be required to underpin growth. In recent days the iron ore price has broken down through the US\$50/t level (US\$180 peak post GFC) and many commentators expect the Australian currency to fall further against the USD. This would be supportive for the off-shore earners such as Resmed, CSL, Slater & Gordon, Macquarie and Sonic, which we own across the Portfolios. We also met BHP Billiton during our visit and while we remain impressed with management and their targets to reduce costs and improve efficiencies by \$10bn p.a., the commodities downturn keeps us underweight the sector and BHP Billiton.

Another potential opportunity for investors going forward is corporate activity. In Australia there have been 83 initial public offerings (IPOs) in the 12 months to February 2015 with their value increasing by 20% over the prior year to A\$21.7bn. During 2015 we expect this

elevated level of activity to continue but we will be careful to leverage off our internal research process to sort out the good from bad. At Devon, whenever we are reviewing major transactions such as IPO's we engage extensively with management, competitors and customers to fully understand the business and sector that it operates in. When this analysis is complete we are able to internally model the company and do a full valuation review.

A final point for New Zealand investors looking at Australian equities to consider is the recent strength of the NZD. Over the last two years the ASX 200 Accumulation index has risen 15% pa in local currency terms but only 3% pa in NZD terms. With the currency cross rate now approaching parity, a NZ investor with unhedged Australian exposure stands to enjoy a strong tailwind should the currency trend reverse.